

1998 ANNUAL REPORT

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Illinois-American
Water Company

An American Water System Company

ILLINOIS-AMERICAN WATER COMPANY

An American Water System Company
300 North Water Works Drive
Belleville, Illinois 62223

1998 Board of Directors

J. James Barr, President and Chief Executive Officer
American Water Works Company, Inc.

G. C. Smith, Vice President
American Water Works Company, Inc.

R. G. Lee, President
Illinois-American Water Company

E. H. Gemmill, Director
American Water Works Company, Inc.

P. W. Ware, Director
American Water Works Company, Inc.

J. H. Ware, IV, Director
Utility Consultant

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R. G. Lee	President
R. D. Mitchem	Vice President
C. W. Overath	Vice President & Treasurer
S. A. Schultz	Secretary
D. S. Hobbs	Comptroller

Transfer and Dividend Disbursing Agent for
Cumulative First Preferred Stock, 6% Series:
Union Planters Trust and Investment Company
222 East Main Street
Belleville, Illinois 62222

Management Report

Mission Statement

"To provide the highest quality water service at the lowest price possible while enhancing shareholder value and developing associates in a desirable work environment."

Financially, 1998 was a positive year for Illinois-American Water Company. Net income was strong at \$12,455,161. Overall revenues were \$72,900,112.

There were many reasons for this positive year, but most notably the controls placed on operating and maintenance costs.

During 1998, Illinois-American Water Company continuously emphasized what has been identified by management as its three keys to the company's continued success:

1. Maintain reliable, high-quality service.
2. Control the cost of water and maintain competitive water rates.
3. Increased customer base -- growth.

The company's 1998 accomplishments focus on these three key issues, which are highlighted in this report:

1. Provide & Maintain Quality Service

In 1998, Illinois-American implemented a new customer satisfaction survey for its

Combined Services Operations Center (CSOC) and outside commercial areas. This program is being administered by Working Data Group of Pennsylvania.

The result: 80 percent of customers are "satisfied" or "very satisfied" with the overall quality of service they receive from their water company.

This survey program by Working Data Group is being expanded in 1999.

* The company's new web site -- <http://www.illinoisamerican.com>. --went live in fall 1998. Customers and the general public now have access to the latest information about the company via their computer.

* Illinois-American continues its positive working relationship with EPA through *The Partnership For Safe Water*. In 1998, Partnership goals were met 93 percent of the time.

2. Controlling Costs Of Water

In the Alton District, the company acquired land across from the existing plant for a new plant. Working with the City of Alton avoided a potential lengthy condemnation process. Construction should begin on the new plant in summer 1999 with completion set for December 2000.

* The Illinois EPA has agreed that investor-owned utilities should be included in the State Revolving Fund. Legislation should be introduced in the Illinois General Assembly in 1999. This would allow private companies like Illinois-American to apply for state and federal grants available to improve water systems.

(Continued On Next Page)

3. Enhancing shareholder value...through growth and new business

In the Southern Division, Illinois-American acquired the Village of Shiloh's water system, adding 1,200 new customers. It was the company's first acquisition of a municipal system.

* Service also was initiated to the new Bond Madison Water Company, which brings potable water to rural areas of Bond and Madison counties in the Southern Division, on a sale-for-resale basis.

* In the Northern Division, 90 percent of the CHM project was completed in 1998, adding 500 new customers.

* The company initiated commercial laboratory work as a business enterprise. Some testing contracts were secured for smaller systems, through an agreement with Illinois EPA.

* In the Interurban District, a competitive tariff was secured for a group of Sauget industrial customers under a 15-year contract. A competitive tariff was also secured for the Metro East Municipal Joint Water Agency (MEMJAWA) under a 30-year contract. MEMJAWA is comprised of the City of Columbia and Commonfields of Cahokia Public Water District. These special tariffs were necessary to retain large customers that were considering purchasing water from the City of St. Louis, via a pipeline under the Mississippi River.

Becoming Y2K Ready

Y2K was a top priority in 1998 and continues to be Illinois-American's and the American Water System's top priority in 1999.

Illinois-American is working in conjunction with American Water Works

Company, Inc., and other subsidiaries on this project. This approach allows for sharing plans and processes used to document and test systems and devices.

A Year 2000 checklist includes the actual testing of all devices and actually setting their clocks ahead to Year 2000. Our plan also includes contacting critical vendors and suppliers of Illinois-American, as well as contingency planning to prepare for unforeseen Y2K failures.

Internally, a program to check and test all equipment, software, and computers for Year 2000 compatibility started in 1998 and is being completed.

No new data processing programs are being undertaken until the Y2K program is completed.

Illinois-American is doing everything within its control to be prepared for Y2K.

By all standards, 1998 was a successful year for Illinois-American Water Company.

Report of Independent Accountants

To the Board of Directors
Illinois-American Water Company

In our opinion, the accompanying balance sheet and statement of capitalization and the related statements of income and retained earnings, of cash flows and of common stockholders' equity present fairly, in all material respects, the financial position of Illinois-American Water Company (a wholly-owned subsidiary of American Water Works Company, Inc.) at December 31, 1998 and 1997, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

PricewaterhouseCoopers LLP

January 29, 1999

ILLINOIS-AMERICAN WATER COMPANY
Balance Sheet
(Dollars in thousands)

	December 31,	
	1998	1997
Assets		
Utility plant - at original cost	\$ 312,036	\$ 289,068
Construction work in progress	7,565	5,839
Accumulated depreciation	(86,026)	(79,154)
	<u>233,575</u>	<u>215,753</u>
Non utility property	563	116
Current assets		
Cash	44	34
Customer accounts receivable	5,032	4,809
Allowance for uncollectible accounts	(156)	(169)
Unbilled revenues	3,331	2,932
Federal income tax refund due from associated company	161	360
Materials and supplies	1,128	1,055
Deferred vacation pay	1,041	1,074
Other	368	368
	<u>10,949</u>	<u>10,463</u>
Regulatory and other long-term assets		
Debt and preferred stock expense	2,198	1,487
Expense of rate proceedings	225	453
Deferred programmed maintenance	979	1,250
Net regulatory asset - income taxes recoverable through rates	4,725	4,726
Other	175	287
	<u>8,302</u>	<u>8,203</u>
	<u>\$ 253,389</u>	<u>\$ 234,535</u>
Capital and Liabilities		
Common stock	\$ 56,828	\$ 36,828
Paid-in capital	1,896	1,896
Retained earnings	38,673	35,347
Total common stockholder's equity	<u>97,397</u>	<u>74,071</u>
Preferred stock	848	944
Long-term debt	89,975	78,069
Total capitalization	<u>188,220</u>	<u>153,084</u>
Current liabilities		
Bank debt - pending issuance of securities	1,072	20,978
Current portion of long-term debt	685	83
Accounts payable	3,022	2,189
Accrued taxes	1,329	956
Accrued interest	1,490	1,472
Accrued vacation pay	1,041	1,074
Accrued wages	140	281
Other	3,288	4,211
	<u>12,067</u>	<u>31,244</u>
Regulatory and other long-term liabilities		
Customer advances for construction	3,742	2,497
Deferred income taxes	21,457	21,512
Deferred investment tax credits	2,993	3,139
Accrued other postretirement benefits	842	842
Accrued pension cost	3,266	2,701
Other	442	461
	<u>32,742</u>	<u>31,152</u>
Contributions in aid of construction	20,360	19,055
Commitments and contingencies (Note 16)	-	-
	<u>\$ 253,389</u>	<u>\$ 234,535</u>

The accompanying notes are an integral part of these financial statements

ILLINOIS-AMERICAN WATER COMPANY**Statement of Income****(Dollars in thousands)**

	Year ended December 31,	
	1998	1997
Operating revenues	\$ 72,900	\$ 65,151
Operating expenses		
Operation and maintenance	33,822	32,684
Depreciation and amortization	10,127	9,230
General taxes	3,343	2,988
State income taxes	615	612
Federal income taxes	6,464	4,876
	<u>54,371</u>	<u>50,390</u>
Utility operating income	18,529	14,761
Other income		
Allowance for other funds used during construction	157	635
Miscellaneous other income	281	91
	<u>18,967</u>	<u>15,487</u>
Other deductions		
Amortization of preferred stock expense	1	1
Miscellaneous other deductions	22	16
Taxes on other income and deductions		
General	8	(4)
State income	8	3
Federal income	83	25
	<u>122</u>	<u>41</u>
Income before interest charges	<u>18,845</u>	<u>15,446</u>
Interest charges		
Interest on long-term debt	6,108	5,611
Amortization of debt expense	140	115
Interest on bank debt	208	484
Other interest	28	1
Allowance for borrowed funds used during construction	(94)	(467)
	<u>6,390</u>	<u>5,744</u>
Net income	<u>\$ 12,455</u>	<u>\$ 9,702</u>

ILLINOIS-AMERICAN WATER COMPANY**Statement of Retained Earnings****(Dollars in thousands)**

	Year ended December 31,	
	1998	1997
Retained earnings at beginning of year	\$ 35,347	\$ 32,808
Net income	12,455	9,702
	<u>47,802</u>	<u>42,510</u>
Dividends		
Preferred stock	54	60
Common stock	9,075	7,103
	<u>9,129</u>	<u>7,163</u>
Retained earnings at end of year	<u>\$ 38,673</u>	<u>\$ 35,347</u>

ILLINOIS-AMERICAN WATER COMPANY
Statement of Cash Flows
(Dollars in thousands)

	Year ended December 31,	
	1998	1997
Cash flows from operating activities		
Net income	\$ 12,455	\$ 9,702
Adjustments		
Depreciation and amortization	10,127	9,230
Amortization, other	780	815
Allowance for other funds used during construction	(157)	(635)
Provision for deferred income taxes	(56)	168
Amortization of deferred investment tax credits	(253)	(248)
Gain on disposition of properties	-	(6)
Provision for losses on accounts receivable	425	454
Expense of rate proceedings	(8)	(396)
Other, net	(448)	113
Changes in assets and liabilities		
Accounts receivable	(660)	(664)
Unbilled revenue	(399)	(71)
Materials and supplies	(73)	(27)
Other current assets	34	(161)
Accounts payable	833	500
Federal income tax refund due from associated company	199	429
Accrued taxes	373	(47)
Accrued interest	18	230
Accrued pension costs	565	506
Other current liabilities	(1,094)	884
Net cash provided by operating activities	<u>22,661</u>	<u>20,776</u>
Cash flows from investing activities		
Construction expenditures	(25,416)	(32,446)
Acquisitions	(1,650)	-
Allowance for other funds used during construction	157	635
Cost of removal, net of salvage	(797)	(1,060)
Net cash used in investing activities	<u>(27,706)</u>	<u>(32,871)</u>
Cash flows from financing activities		
Proceeds from long-term debt	12,000	-
Proceeds from common stock	20,000	-
Net borrowings under line-of-credit agreement	(19,906)	18,716
Repayment of long-term debt	(88)	(90)
Customer advances and contributions	3,062	830
Redemption of preferred stocks	(96)	(96)
Dividends paid	(9,131)	(7,165)
Debt issuance costs	(786)	(88)
Net cash provided by financing activities	<u>5,055</u>	<u>12,107</u>
Net change in cash	10	12
Cash at beginning of year	34	22
Cash at end of year	<u>\$ 44</u>	<u>\$ 34</u>
Cash paid during the year for:		
interest, net of capitalized amount	<u>\$ 6,232</u>	<u>\$ 5,399</u>
Income taxes	<u>\$ 6,963</u>	<u>\$ 4,963</u>

The accompanying notes are an integral part of these financial statements

Illinois-American Water Company

Statement of Capitalization

(Dollars in thousands, except per share amounts)

	Call Price Per Share	December 31,	
		1998	1997
Common Stockholder's Equity			
Common stock - no par value, authorized 7,500,000 shares in 1998 and 5,000,000 shares in 1997. Outstanding are 5,338,266 shares in 1998 and 4,203,192 shares in 1997.		\$ 56,828	\$ 36,828
Paid-in capital		1,896	1,896
Retained earnings		38,673	35,347
		<u>97,397</u>	<u>74,071</u>
Preferred Stock - \$100 par value			
Without mandatory redemption requirements:			
Cumulative first preferred stocks - authorized 15,503 shares			
6.00% series, 5,500 shares issued and outstanding	\$105.00	550	550
		<u>550</u>	<u>550</u>
With mandatory redemption requirements:			
Cumulative preferred stocks - authorized 60,000 shares			
4-7/8% series, 480 shares issued and outstanding in 1998, 640 in 1997	\$100.00	48	64
5-1/4% series, 100 shares issued and outstanding in 1998, 300 in 1997	\$100.00	10	30
6-3/4% series, 480 shares issued and outstanding in 1998, 600 in 1997	\$100.00	48	60
6-7/8% series, 1,920 shares issued and outstanding in 1998, 2,400 in 1997	\$100.00	192	240
		<u>298</u>	<u>394</u>
Long-Term Debt			
General mortgage bonds			
9.71% series due 2000		5,100	5,100
8.54% series due 2001		5,100	5,100
7.19% series due 2002		21,000	21,000
6.57% series due 2004		16,800	16,800
6.76% series due 2005		7,000	7,000
9-5/8% series due 2019		6,000	6,000
6.10% series due 2022		11,000	11,000
5.15% series due 2023		5,975	5,980
5.00% series due 2028		12,000	-
Notes payable		596	-
Capital lease		89	172
		<u>90,660</u>	<u>78,152</u>
Less: Current portion of capital lease and notes payable		(685)	(83)
		<u>89,975</u>	<u>78,069</u>
		<u>\$ 188,220</u>	<u>\$ 153,084</u>

The accompanying notes are an integral part of these financial statements

Illinois-American Water Company
Statement of Common Stockholder's Equity
(Dollars in thousands, except per share amounts)

	<u>Common Stock</u>		<u>Paid-in</u>	<u>Retained</u>	<u>Common</u>
	<u>Shares</u>	<u>Par Value</u>	<u>Capital</u>	<u>Earnings</u>	<u>Stockholder's</u>
					<u>Equity</u>
BALANCE AT DECEMBER 31, 1996	4,203	\$ 36,828	\$ 1,896	\$ 32,808	\$ 71,532
Net income	---	---	---	9,702	9,702
Dividends					
Preferred stocks	---	---	---	(60)	(60)
Common stock, \$1.69 per share	---	---	---	(7,103)	(7,103)
BALANCE AT DECEMBER 31, 1997	4,203	\$ 36,828	\$ 1,896	\$ 35,347	\$ 74,071
Net income	---	---	---	12,455	12,455
Issuance of common stock	1,135	20,000			20,000
Dividends					
Preferred stocks	---	---	---	(54)	(54)
Common stock, \$1.70 per share	---	---	---	(9,075)	(9,075)
BALANCE AT DECEMBER 31, 1998	<u>5,338</u>	<u>\$ 56,828</u>	<u>\$ 1,896</u>	<u>\$ 38,673</u>	<u>\$ 97,397</u>

The accompanying notes are an integral part of these financial statements

ILLINOIS-AMERICAN WATER COMPANY

Notes to Financial Statements

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(Dollars in thousands)

Note 1: Organization and Operation

Illinois-American Water Company (the Company) provides water service to 147,668 customers. This service is provided in 65 communities located in 7 counties in the state of Illinois. As a public utility operating in Illinois, the Company functions under rules and regulations prescribed by the Illinois Commerce Commission (the Commission). The Company is a wholly-owned subsidiary of American Water Works Company, Inc. (American).

Note 2: Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the period. Actual results could differ from these estimates.

Regulation

The Company has incurred various costs and received various credits which have been reflected as regulatory assets and liabilities on its balance sheet. Accounting for such costs and credits as regulatory assets and liabilities is in accordance with Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation." (SFAS No. 71). This statement sets forth the application of generally accepted accounting principles for those companies whose rates are established by or are subject to approval by an independent third-party regulator. Under SFAS No. 71, regulated companies defer costs and credits on the balance sheet as regulatory assets and liabilities when it is probable that those costs and credits will be recognized in the rate making process in a period different from the period in which they would have been reflected in income by an unregulated company. These deferred regulatory assets and liabilities are then reflected in the income statement in the period in which the same amounts are reflected in the rates charged for service.

Property, Plant and Equipment

Additions to utility plant and replacements of retirement units of property are capitalized. Costs include material, direct labor and such indirect items as engineering and supervision, payroll taxes and benefits, transportation and an allowance for funds used during construction. Repairs, maintenance and minor replacements of property are charged to current operations. The costs incurred to acquire and internally develop computer software for internal use are capitalized as a unit of property. The cost of property units retired in the ordinary course of business plus removal cost (net of salvage) is charged to accumulated depreciation. The cost of property, plant and equipment is depreciated using the straight-line method. The depreciation rates, based on the average balance of depreciable property, were 3.5% in 1998 and 3.6% in 1997.

In accordance with the Commission's regulations, depreciation on contributed facilities is charged to contributions in aid of construction. Such depreciation amounted to \$512 in 1998 and \$490 in 1997.

Utility plant acquisition adjustments include the difference between the purchase price of utility plant and its original cost (less accumulated depreciation) when first devoted to public service and are being amortized to income over a five to twenty-eight year period.

ILLINOIS-AMERICAN WATER COMPANY

Notes to Financial Statements

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(Dollars in thousands)

Cash and Cash Equivalents

Substantially all of the Company's cash is invested in interest bearing accounts. The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. There were no cash equivalents held at December 31, 1998 or 1997.

Materials and Supplies

Materials and supplies are stated at average cost.

Regulatory and Long-Term Assets

The Company has recorded a regulatory asset for the additional revenues expected to be realized as the tax effects of temporary differences previously flowed through to customers reverse. These temporary differences are primarily related to the difference between book and tax depreciation on property placed in service before the adoption by the Commission of full normalization for rate making purposes.

The regulatory asset for income taxes recoverable through rates is net of the reduction expected in future revenues as deferred taxes previously provided, attributable to the difference between the state and federal income tax rates under prior law and the current statutory rates, reverse over the average remaining service lives of the related assets.

Debt expense is amortized over the lives of the respective issues. Call premiums on the redemption of long-term debt, as well as unamortized debt expense, are deferred and amortized to the extent they will be recovered through future service rates. Expenses of preferred stock issues without sinking fund provisions are amortized over thirty years from the date of issue; expenses of issues with sinking fund provisions are charged to operations as shares are retired.

Expense of rate proceedings is deferred and amortized on a straight-line basis over a two-to-five year period, as authorized by the Commission in their determination of rates charged for service.

Preliminary survey and investigation charges generally relate to future construction projects. Management believes these costs will ultimately be recovered through rates.

Programmed maintenance costs are deferred and amortized to current operations on a straight-line basis over periods ranging from six to ten years, as authorized by the Commission in their determination of rates charged for service.

Other Current Liabilities

Other current liabilities at December 31, 1998 and 1997 include payables to banks of \$2,764 and \$3,487, respectively, which represent checks issued but not presented to the banks for payment, net of the related bank balance.

Advances and Contributions in Aid of Construction

The Company may receive advances and contributions to fund construction necessary to extend service to new areas. As determined by the Commission, advances for construction are refundable for limited periods of time as new customers begin to receive service. Amounts which are no longer refundable are reclassified to contributions in aid of construction.

ILLINOIS-AMERICAN WATER COMPANY

Notes to Financial Statements

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(Dollars in thousands)

Utility plant funded by advances and contributions is excluded from rate base and is not depreciated for rate making purposes. Generally, advances and contributions received during the period of January 1, 1987 through June 12, 1996 have been included in taxable income and the related property is depreciable for tax purposes. As a result of a tax law change, advances and contributions received subsequent to June 12, 1996 are excluded from taxable income.

Recognition of Revenues

Water service revenues for financial reporting purposes include amounts billed to customers on a cycle basis and unbilled amounts based on estimated usage from the date of the latest meter reading to the end of the accounting period.

Income Taxes

The Company, its parent and affiliates participate in a consolidated federal income tax return. Federal income tax expense for financial reporting purposes is provided on a separate return basis, except that the federal income tax rate applicable to the consolidated group is applied to separate company taxable income and the benefit of net operating losses, if any, is recognized currently.

Certain income and expense items are accounted for in different time periods for financial reporting than for income tax reporting purposes. Deferred income taxes have been provided on the difference between the tax bases of assets and liabilities and the amounts at which they are carried in the financial statements. These deferred income taxes are based on the enacted tax rates anticipated to be in effect when such temporary differences are expected to reverse. Regulatory assets and liabilities are recognized for the effect on revenues expected to be realized as the tax effects of temporary differences previously flowed through to customers reverse.

Investment tax credits have been deferred and are being amortized to income over the average estimated service lives of the related assets.

Effective December 1, 1990, the Company was directed to prospectively defer state investment tax credits and amortize the tax credits over the average life of the related property. State investment tax credits generated prior to that date were recorded as a reduction to the state tax liability on a flow-through basis.

Allowance for Funds Used During Construction (AFUDC)

AFUDC is a non-cash adjustment to income with a corresponding charge to utility plant which represents the cost of borrowed funds and a return on equity funds devoted to plant under construction. AFUDC is recorded to the extent permitted by the Commission.

Environmental Costs

Environmental expenditures that relate to current operations or provide a future benefit are expensed or capitalized as appropriate. Remediation costs that relate to an existing condition caused by past operations are accrued when it is probable that these costs will be incurred and can be reasonably estimated. There were no remediation costs accrued at December 31, 1998 and 1997.

ILLINOIS-AMERICAN WATER COMPANY

Notes to Financial Statements

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(Dollars in thousands)

Asset Impairment

Long-lived assets and certain identifiable intangible assets held and used by the Company are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets, on a separate entity basis, may not be recoverable. If the sum of the future cash flows expected to result from the use of the assets and their eventual disposition is less than the carrying amount of the assets, an impairment loss is recognized. Measurement of an impairment loss would be based on the fair value of the assets. A regulatory asset is charged to earnings if and when future recovery in rates of that asset is no longer probable.

Note 3 - Utility Plant

The components of utility plant by category at December 31 are as follows:

	<u>1998</u>	<u>1997</u>
Water plant		
Sources of supply	\$ 8,303	\$ 6,613
Treatment and pumping	87,110	85,758
Transmission and distribution	120,533	108,412
Services, meters, and fire hydrants	66,800	61,743
General structures and equipment	29,290	26,542
Construction work in progress	<u>7,565</u>	<u>5,839</u>
	319,601	294,907
Less - accumulated depreciation	<u>86,026</u>	<u>79,154</u>
	<u>\$ 233,575</u>	<u>\$ 215,753</u>

Note 4: Preferred Stocks

Preferred stock agreements require annual sinking fund payments of \$86 in 1999, \$76 in 2000, \$76 in 2001, and ending with \$60 in 2002.

Preferred stock agreements contain provisions for redemption at various prices on thirty days' notice, at the Company's discretion. In the event of liquidation, whether voluntary or involuntary, the shares of each series are redeemable at \$100 per share. All call prices are on thirty days' notice plus accrued dividends.

Note 5: Long-Term Debt

Maturities of long-term debt will amount to \$89 in 1999; \$5,100 in 2000 and 2001; and \$21,000 in 2002. There are no maturities in 2003.

The general mortgage bond indentures contain clauses restricting the declaration of common stock dividends and other distributions on capital stock if common stockholders' equity falls below a specified amount. There were no restrictions at December 31, 1998.

The general mortgage bonds are issuable in series. No bonds senior to the general mortgage bonds may be issued so long as the general mortgage bonds are outstanding. The amount of bonds authorized is unlimited as long as long-term debt does not exceed 65% of capitalization. Long-term debt is secured by utility plant.

The Company's capital lease, the Peoria office building, totals \$615 at December 31, 1998 and 1997. Associated accumulated amortization was \$587 and \$556 at December 31, 1998 and 1997, respectively. Amortization of the capitalized leased asset was \$31 in 1998 and 1997.

ILLINOIS-AMERICAN WATER COMPANY

Notes to Financial Statements

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(Dollars in thousands)

Note 6: Compensating Balances and Bank Debt

Throughout the year, the Company maintains a line of credit. The maximum line of credit available during 1998 was \$31,375. At December 31, 1998, the available line of credit was \$6,750 and the total unused line of credit was \$5,678. The Company historically finances short-term cash requirements by borrowings from banks which are repaid with the proceeds of long-term financings. Borrowings under this line of credit are payable on demand and bear interest at variable rates. The agreement with the bank has no compensating balance requirement.

The maximum amount of short-term bank borrowings outstanding during 1998 was \$24,308, and the average amount outstanding during the year was \$3,578. The weighted average annual interest rate on these borrowings during 1998 was 5.99%, and the interest rate at December 31, 1998 was 5.75%.

Note 7: Financings

During 1998, the Company completed the following financings:

<u>Date</u>	<u>Proceeds</u>	<u>Issue</u>
02/24/98	\$12,000	General mortgage tax exempt bonds, 5% series, due February 1, 2028
02/24/98	\$20,000	Common stock, 1,135,074 shares, no par value

The general mortgage bonds were sold to an underwriter at a price equal to the principal amount. The underwriter resold the bonds to the general public. The common stock was issued to the Company's parent, American Water Works Company, Inc. Proceeds of these financings were used to repay bank debt, provide working capital, and finance construction.

Note 8: General Taxes

Components of general tax expense for the years presented in the statement of income are as follows:

	<u>1998</u>	<u>1997</u>
General taxes:		
Property	\$ 850	\$ 651
Payroll	1,079	1,071
Invested capital tax	1,365	1,216
Other general taxes	<u>57</u>	<u>46</u>
	<u>\$ 3,351</u>	<u>\$ 2,984</u>

ILLINOIS-AMERICAN WATER COMPANY

Notes to Financial Statements

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(Dollars in thousands)

Note 9: Income Taxes

Components of income tax expense for the years presented in the statement of income are as follows:

	<u>1998</u>	<u>1997</u>
State income taxes:		
Current	\$ 492	\$ 396
Deferred		
Current	-	-
Non-current	42	86
Investment tax credits deferred, net of amortization	<u>89</u>	<u>133</u>
	<u>\$ 623</u>	<u>\$ 615</u>
Federal income taxes:		
Current	\$ 6,838	\$ 5,031
Deferred		
Current	2	2
Non-current	(58)	103
Amortization of deferred investment tax credits	<u>(235)</u>	<u>(235)</u>
	<u>\$ 6,547</u>	<u>\$ 4,901</u>

A reconciliation of income tax expense at the statutory federal income tax rate to the actual income tax expense is as follows:

	<u>1998</u>	<u>1997</u>
Income tax at statutory rate of 35%	\$ 6,869	\$ 5,326
Increases (decreases) resulting from -		
State taxes, net of federal income taxes	405	400
Flow through differences	152	138
Amortization of investment tax credits	(235)	(235)
Other, net	<u>(21)</u>	<u>(113)</u>
Actual income tax expense	<u>\$ 7,170</u>	<u>\$ 5,516</u>

ILLINOIS-AMERICAN WATER COMPANY**Notes to Financial Statements****Page 7**

(Dollars in thousands)

The following table provides the components of the net deferred tax liability at December 31:

	<u>1998</u>	<u>1997</u>
Deferred tax assets:		
Advances and contributions	\$ 9,548	\$ 8,538
Deferred investment credits	925	1,018
Other	<u>1,889</u>	<u>1,691</u>
	<u>\$ 12,362</u>	<u>\$ 11,247</u>
Deferred tax liabilities:		
Utility plant, principally due to depreciation differences	\$ 31,379	\$ 30,139
Income taxes recoverable through rates	1,355	1,365
Other	<u>1,085</u>	<u>1,255</u>
	<u>\$ 33,819</u>	<u>\$ 32,759</u>
Net deferred tax liabilities	<u>\$ 21,457</u>	<u>\$ 21,512</u>

No valuation allowances were required on deferred tax assets at December 31, 1998 and 1997.

Note 10: Rate Matters

As necessary, the Company applies to the Commission for changes in the rates charged for service. The rate increase request is based on the level of operating expenses and capital costs that are expected to be in effect when the rates become effective. The revenues requested are based on projected sales during the future test year selected by the Company as the base period.

Effective December 28, 1997, the Company received approval from the Commission to increase its rates for service as follows:

<u>District</u>	<u>Percentage increase</u>	<u>Estimated annual revenue increase</u>	<u>Approximate effect of increase on 1997 revenues</u>
Alton	8.88%	\$ 690	\$ 9
Cairo	10.90%	91	1
Interurban	9.70%	3,086	35
Pekin	10.07%	422	4
Peoria	15.14%	<u>3,013</u>	<u>28</u>
		<u>\$ 7,302</u>	<u>\$ 77</u>

ILLINOIS-AMERICAN WATER COMPANY

Notes to Financial Statements

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(Dollars in thousands)

Note 11: Employee Benefit Plans

Employees' Stock Ownership Plan

The Company participates in an Employees' Stock Ownership Plan which provides for beneficial ownership of American common stock by all employees of American and its subsidiaries who are not included in a bargaining unit. Each participating employee can elect to contribute an amount that does not exceed 2% of their wages for the preceding year. In addition to the employee's participation, the Company makes a contribution equivalent to 1/2% of each participant's qualified compensation for the preceding year, and matches 100% of the contribution by each participant. The Company expensed contributions of \$116 for 1998 and \$116 for 1997 that it made to the plan. The trustee of the plan may purchase shares of American common stock from American or from a qualified stockholder at the prevailing market price or on the open market.

Savings Plan for Employees

The Company participates in a 401(k) Savings Plan for Employees sponsored by American for all employees who have more than six months of service. Employee contributions are invested at the direction of the employee in one or more funds including a fund consisting entirely of American common stock. Effective January 1, 1998 the Company began matching 50% of the first 4% of each employee's wages contributed to the plan. Prior to this date the Company had matched 45% of the first 4% of each employee's wages contributed to the plan. The company expensed matching contributions to the plan totaling \$206 for 1998 and \$203 for 1997. All of the Company's matching contributions are invested in the fund of American common stock. The trustee of the plan may purchase shares of American common stock from American or from a qualified stockholder at the prevailing market price or on the open market.

Note 12: Postretirement Benefits

Pension Benefits

The Company participates in a noncontributory defined benefit pension plan covering substantially all employees of American and its subsidiaries. Benefits under the plan are based on the employee's years of service and average annual compensation for those 60 consecutive months of employment which yield the highest average. Pension cost of the Company is based on an allocation from American of the total cost related to the plan. Information regarding accumulated and projected benefit obligations is not prepared at the subsidiary level. The Company's funding policy is to contribute at least the minimum amount required under the Employee Retirement Income Security Act of 1974. The Company made no contributions to the plan in 1998 or 1997 as the plan was fully funded.

Postretirement Benefits Other Than Pensions

The Company participates in an American plan that provides certain life insurance benefits for retired employees and certain health care benefits for retired employees and their dependents. Substantially all employees may become eligible for those benefits if they reach retirement age while still working for the Company. Retirees and their dependents under age 65 can elect either a comprehensive medical plan under which covered expenses are paid at 80% after an annual deductible has been satisfied or, effective January 1, 1996, a managed care plan that requires copayments. Employees who elect to retire prior to attaining age 65 are required to make contributions towards their medical coverage until attaining age 65. Retirees and their dependents age 65 and over are covered by a Medicare supplement plan. Costs of the Company are based on an allocation from American of the total cost related to the plan. Information regarding accumulated and projected benefit obligations is not prepared at the subsidiary level. The Company made contributions to trust funds established for these postretirement benefits of \$1,545 in 1998 and \$1,625 in 1997. The Company's policy is to fund postretirement benefits costs accrued.

ILLINOIS-AMERICAN WATER COMPANY

Notes to Financial Statements

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(Dollars in thousands)

Note 13: Related Party Transactions

American Water Works Service Company, Inc. (Service Company), an affiliate, provides certain management services (administration, accounting, data processing, engineering, etc.) to the Company and other operating water companies in the American Water Works System on an at-cost, not-for-profit basis in accordance with a management and service agreement. Purchases of such services by the Company were accounted for as follows:

	<u>1998</u>	<u>1997</u>
Included in operation and maintenance expense as a charge against income	\$ 1,159	\$ 1,120
Capitalized in various balance sheet accounts	<u>294</u>	<u>287</u>
	<u>\$ 1,453</u>	<u>\$ 1,407</u>

The Company has operating agreements with American Commonwealth Management Services Company, Inc. (ACMS), an affiliate, for the lease (and/or purchase) of granular activated carbon at three of the Company's water treatment plants. The agreements provide for ACMS to regenerate the spent carbon and return it to the water treatment plant where it originated. Under the terms of the agreements, ACMS will provide carbon for a period of 24 or 36 months. The carbon is scheduled for replacement at 12, 24, or 36 month intervals and is warranted to perform to specific standards during the period. The Company paid \$273 in 1998 and \$304 in 1997 to ACMS under these agreements.

Note 14: Fair Values of Financial Instruments

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Current assets and current liabilities: The carrying amount reported in the balance sheet for current assets and current liabilities approximates their fair values.

Preferred stocks with mandatory redemption requirements and long-term debt: The fair values of the Company's preferred stocks with mandatory redemption requirements and long-term debt are estimated using discounted cash flow analyses based on the Company's current incremental financing rates for similar types of securities.

The carrying amounts and fair values of the Company's financial instruments at December 31 are as follows:

	<u>1998</u>		<u>1997</u>	
	<u>Carrying Amount</u>	<u>Fair Value</u>	<u>Carrying Amount</u>	<u>Fair Value</u>
Preferred stock with mandatory redemption requirements	\$ 298	\$ 301	\$ 394	\$ 389
Long-term debt, including current maturities	\$ 90,571	\$ 98,144	\$ 77,980	\$ 82,907

Note 15: Operating Leases

The Company has entered into operating leases involving certain facilities and equipment. Rental expenses under operating leases were \$362 for 1998 and \$412 for 1997. Operating leases for equipment expire over the next five years. Certain leases have renewal options ranging from one to five years.

ILLINOIS-AMERICAN WATER COMPANY

Notes to Financial Statements

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(Dollars in thousands)

At December 31, 1998, the minimum annual future rental commitments under operating leases that have initial or remaining noncancellable lease terms in excess of one year are \$304 in 1999, \$277 in 2000, \$130 in 2001, \$4 in 2002, and \$0 in 2003.

Note 16: Commitments and Contingencies

The Company's construction program for 1999 is estimated to cost approximately \$34,000. Commitments have been made in connection with certain projects included in this program.

The Company is routinely involved in legal actions. In the opinion of management, none of these matters will have a material adverse effect, if any, on the financial position or results of operations of the Company.

Note 17: Acquisitions and Dispositions

During 1998, the Company acquired six water systems. Five of these acquisitions were of small water associations that provided 484 additional customers. The assets of these five systems were contributed to the Company in the amount of \$69 and were recorded to contributions in aid of construction.

One system, the Village of Shiloh, was a municipally-owned system of 1,215 customers that had previously been a sale-for-resale customer of the Company. It was acquired for an aggregate price of \$2,246 consisting of an initial payment of \$1,650 and five annual payments totaling \$596. Because the remaining obligation is payable on demand, it has been reclassified in the current portion of long-term debt.

**Additional Information
(UNAUDITED)**

ILLINOIS-AMERICAN WATER COMPANY
Historical Review (Unaudited)

For the years ended December 31,	1998	1997	1996	1995	1994	1993	1988
Utility plant - at original cost	\$312,036,241	\$289,068,293	\$259,668,707	\$240,855,339	\$229,699,102	\$218,212,042	\$167,327,531
Accumulated depreciation	(86,026,259)	(79,154,010)	(72,003,312)	(66,068,662)	(60,306,805)	(55,106,584)	(36,895,964)
Net utility plant	\$226,009,982	\$209,914,283	\$187,665,395	\$174,786,677	\$169,392,297	\$163,105,458	\$130,431,567
Net plant per customer	\$1,531	\$1,440	\$1,292	\$1,210	\$1,176	\$1,138	\$920
Construction expenditures	\$25,416,070	\$32,446,479	\$22,844,914	\$13,423,294	\$15,268,415	\$11,223,983	\$5,360,914
Total assets	\$253,388,784	\$234,534,958	\$210,818,120	\$201,888,981	\$194,775,846	\$191,164,429	\$145,553,392
Capitalization at year end							
Common equity	\$97,395,960	\$74,070,963	\$71,531,429	\$69,176,862	\$60,963,785	\$58,971,317	\$39,667,318
Preferred stock	848,000	944,000	1,040,000	1,210,000	1,494,000	1,778,000	3,234,000
Long-term debt - Includes current portion	90,659,901	78,151,858	78,242,054	78,301,468	79,351,758	62,594,326	56,332,631
	\$188,903,861	\$153,166,821	\$150,813,483	\$148,688,330	\$141,809,543	\$123,343,643	\$99,233,949
Customers served							
Residential	130,876	129,632	129,450	128,766	128,394	127,666	126,024
Commercial	14,100	13,555	13,409	13,489	13,527	13,597	13,769
Industrial	324	331	335	329	327	327	326
Fire service	1,203	1,227	1,166	1,151	1,107	1,070	880
Public and other	1,165	995	931	705	701	706	797
	147,668	145,740	145,291	144,440	144,056	143,366	141,796
Water sales (thousand gallons)							
Residential	8,271,130	8,450,440	8,987,895	8,623,995	8,485,856	7,952,710	9,125,796
Commercial	4,726,797	4,639,637	4,787,621	4,812,870	4,713,038	4,358,498	4,624,443
Industrial	6,609,209	6,401,324	6,222,472	5,986,782	6,066,361	5,965,024	7,104,135
Public and other	5,923,859	5,901,133	5,786,972	5,629,413	5,415,826	5,083,791	5,369,020
	25,530,995	25,392,534	25,784,960	25,053,060	24,681,081	23,360,023	26,223,394
Annual sales per customer (thousand gallons)	173	174	177	173	171	163	185
Operating revenues							
Water service							
Residential	\$37,617,442	\$34,694,061	\$34,768,977	\$32,198,985	\$31,994,276	\$30,384,328	\$24,167,384
Commercial	12,322,987	10,719,463	10,791,273	9,906,892	9,816,062	9,199,573	7,492,215
Industrial	8,624,434	7,733,369	7,698,801	6,862,394	6,964,120	6,710,457	5,890,531
Fire service	4,531,024	3,337,298	3,345,358	3,444,393	3,398,672	3,410,950	3,707,657
Public and other	9,289,561	8,123,268	7,846,667	7,009,323	6,749,840	6,331,041	5,531,276
Other water revenues	514,664	543,754	311,102	58,206	55,569	58,577	54,278
	\$72,900,112	\$65,151,213	\$64,762,178	\$59,480,193	\$58,978,539	\$56,094,926	\$46,843,341
Annual revenue per customer	\$494	\$447	\$446	\$412	\$409	\$391	\$330
Net income	\$12,455,161	\$9,701,981	\$9,482,685	\$7,586,327	\$7,350,433	\$5,882,261	\$5,757,354
Coverage ratios							
On long-term debt interest before income taxes	4.2	3.6	3.6	3.0	3.0	2.9	2.7
On total interest before income taxes	4.0	3.3	3.6	2.9	2.9	2.6	2.4
On total fixed charges including preferred dividends:							
Before income taxes	4.0	3.2	3.5	2.9	2.8	2.6	2.3
After income taxes	2.9	2.4	2.6	2.2	2.1	2.0	1.8